Fitch Revises Rating Watch to Positive on $1.7B San Diego, California Debt Ratings

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Fitch Ratings-San Francisco-27 March 2008: Fitch Ratings revises the Rating Watch to Positive from Negative on the ratings of $1.7 billion of debt issued by the City of San Diego, California (the city) and related entities, secured by the city's tax pledge, lease rental payments, and water and wastewater enterprise system revenue. These debt obligations were downgraded by Fitch and kept on Rating Watch Negative on May 27, 2005. The affected debt is detailed below.

The Rating Watch revision reflects the city's release of its audited financial statements for fiscal years 2003-2006, which had been delayed considerably due to concerns of the fiscal 2003 auditor, KPMG LLP, primarily regarding the city's internal financial controls. Following KPMG's resolution of their issues, the fiscal 2003 audit was released on March 12, 2007. The audits for fiscals 2004, 2005 and 2006 followed, audited by Macias Gini & O'Connell. Fitch's initial review of the audits reveals adequate operations, debt service coverage and reserve levels.

Fitch believes that these results, coupled with the city's underlying economic diversity, strength and enterprise fund financial flexibility, are likely consistent with higher ratings than those currently assigned. Over the coming months, Fitch will evaluate the audited financial results in greater detail and review audited or unaudited fiscal 2007 finances, projections for fiscal 2008 and the city's five-year financial outlook for fiscal years 2009-2013. Fitch's evaluation of the city's credit quality will also focus on the San Diego City Employees' Retirement System funding status and annual costs, since the city appears unable to meet the June 30, 2008 deadline for contributing $600 million toward reducing the system's unfunded liability as set in a memorandum of understanding one of its with labor groups.

Notes to the financial statements detail the Securities and Exchange Commission's Nov. 2006 order sanctioning the city for securities fraud stemming from inadequate disclosure of its pension system's rising unfunded liability and the city's underfunding of the system. The city consented to the order's issuance without denying or admitting the findings. The notes also discuss the numerous investigations that have taken place relating to the disclosure problems and pension system underfunding, as well as changes implemented as a result of these reviews and the initial events. Fitch views these internal changes as having a positive impact on credit quality.

The recently released financial reports show the general fund running about break-even operations for fiscals 2005 and 2006, following a moderate operating loss in fiscal 2004. The ending general fund balance remained satisfactory throughout the period. The city's diverse tax structure benefited from strong economic growth, enabling the city to cover rising fixed costs, largely pension funding and labor expenses. The general fund ended fiscal 2006 with a $61.6 million total fund balance, a satisfactory 6.8% of expenditures and transfers out. The unreserved balance was $40.4 million, 4.4% of spending. Additional financial cushion is provided by reserves held in special revenue funds, with some restriction on use for certain general government-type purposes.

For the water and wastewater utilities, the financial reports generally point to stable operations and adequate to good annual debt service (ADS) coverage through fiscal 2006. ADS coverage for both the water and wastewater senior lien obligations was 3.0 times (x) and 1.5x, respectively for fiscal 2006. For the same period, liquidity was also favorable for both utilities, in excess of 215 days of cash and working capital. Financial margins should remain adequate through the medium term despite relatively large five-year capital plans that anticipate future leveraging as a result of a package of rate increases for fiscals 2008-2011 that were approved by the city in 2007.

Fitch's analysis for these ratings will also focus on recent developments in the city's economy, particularly deterioration in the residential property sector. Residential building permit figures have declined for several years, and weak conditions are now evident through a dramatic drop in the median home sale price. The median single family home price dropped 14% from the fourth quarter 2005-fourth quarter 2007, after having risen a high 117% from the fourth quarter 2000-fourth quarter 2005. The median condo price experienced a similar decline after a smaller but still strong 66% price increase during the same periods. Fitch will monitor developments in this sector as well as other economic indicators.

Fitch has placed the following ratings on Rating Watch Positive. Dollar amounts are in Par ($ mil):

*San Diego

--$10.7 General Obligation bonds 'BBB+';
--$12.3 Certificates of Participation (1993 Balboa Park/Mission Bay Park) series 2003 'BBB-'.

*San Diego Public Facilities Financing Authority
--$23.3 Lease revenue bonds series 2002B 'BBB-';
--$282.4 Subordinated water revenue bonds 'BBB';
--$923.9 Sewer revenue bonds 'BBB+'.

*San Diego Metropolitan Transit Dev. Board
--$13.4 Lease revenue refunding bonds series 2003 'BBB-'.

*Convention Center Expansion Financing Authority
--$178.4 Lease revenue bonds series 1998A 'BBB-'.

*San Diego Facilities and Equipment Leasing Corporation
--$262.8 Certificates of undivided interest series 1998 (secured by a senior lien on water revenues) 'BBB+'.

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